C. SNF & ICF - Special Class - Nursing Facility at the Benton Services Center

1. Reimbursement Methodology and Rates Effective July 1, 1983 and Subsequent Years

The Nursing Facility at the Benton Services Center will be reimbursed on an actual cost reimbursement system with provisions for retrospective adjustments to ensure reimbursement of actual allowable and reasonable costs. Per diem rates established by resident level of care shall be changed as a result of adjustments to the semi-annual cost reports resulting from provider corrections, desk reviews, or audits, and will be retrospectively adjusted to the first day of the applicable cost report period.

2. Overpayments/Underpayments

Overpayments/underpayments resulting from Section 1-12 administrative errors shall be handled through the vendor payment by recouping overpayments and reimbursing underpayments.

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2-5 Mandatory Changes

The Department of Human Services acknowledges that State laws passed by the Arkansas General Assembly and administrative rules promulgated by the Division of Medical Services occasionally require the state's long term care facilities to incur costs which were not incurred prior to the adoption of the law or rule. DHS will assess the impact of newly required costs and, when warranted, seek additional reimbursement through the state and federal executive and legislative agencies. The Division of Medical Services will implement any available additional reimbursement, including appropriate retroactive payments, within the quarter following all necessary approvals, appropriation, and funding.

DHS will inform state and federal agencies proposing new nursing facility mandates of the projected costs, if any, of such mandates. If a proposed mandate would substantially increase costs without attendant state and federal funding, DHS will object to implementing the mandate without corresponding state and federal funding.

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Chapter 3 - Allowable Costs

3-1 General Information

A. This chapter sets forth principles for determining the allowable costs for the facilities which:

1. Meet the definition of a Nursing Facility (NF) under 42 CFR Part 483, Subpart B, if licensed and certified as a NF.

2. Meet the definition of an Intermediate Care Facility for the Mentally Retarded (ICF/MR) under 42 CFR Part 483, Subpart I, if licensed and certified as an ICF/MR.

3. Meet certification requirements to participate in the Medicaid program as a NF or ICF/MR.

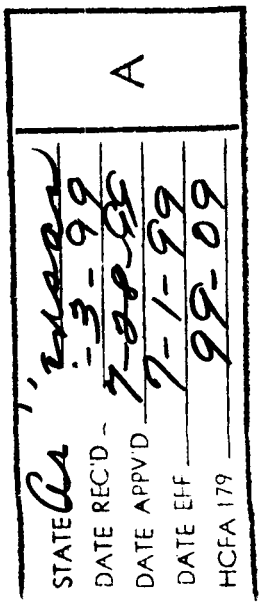
4. Are primarily engaged in providing to residents:

a) skilled nursing care and related services for residents who require medical or nursing care,

b) rehabilitation services for the rehabilitation of injured, disabled, or sick persons,
or

c) on a regular basis, health-related care and services to individuals who because of their mental or physical condition require care and services (above the level of room and board) which can be made available to them only through institutional facilities.

B. The Medicare Provider Reimbursement Manual (HCFA Publication 15-1) and the Federal regulations appropriate to the recognition of costs for facilities under the Medicare program are a supplement to this chapter. A facility shall use the Medicare Provider Reimbursement Manual and Federal regulations for the sole purpose of determining the allowability of a specific cost not determinable by reference to this manual. A facility may not use the Medicare Provider Reimbursement Manual or Federal regulations for a cost that is determined to be unallowable in this chapter. A facility may not use the Medicare Provider Reimbursement Manual or Federal regulations to alter the treatment of a cost provided for in this chapter.



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C. Generally Accepted Accounting Principles (GAAP) as interpreted in the opinions of the American Institute of Certified Public Accountants (AICPA) and in the statements by the Financial Accounting Standards Board (FASB) are a supplement to this chapter. A facility shall use GAAP for cost issues which are not specifically addressed in this chapter, the Medicare Provider Reimbursement Manual, or Federal regulations. A facility may not use GAAP for a cost that is determined to be unallowable in either this chapter, the Medicare Provider Reimbursement Manual, or Federal regulations. A facility may not use GAAP to alter the treatment of a cost provided for in this chapter, the Medicare Provider Reimbursement Manual, or Federal regulations.

D. Allowable costs must be reported on a full accrual basis of accounting. If a facility maintains its internal records on a basis other than the accrual method, it will be necessary to convert to the accrual basis for cost reporting purposes. This does not apply to State owned facilities.

E. The Arkansas Department of Human Services (DHS) defines allowable and unallowable costs to identify expenses which are reasonable and necessary to provide recipient care to Medicaid recipients by an economical and efficient provider. The primary objective of the cost reporting process is to provide adequate data for the determination of fair and reasonable reimbursement rates to providers. To achieve that objective, DHS compiles a rate base consisting, if possible, only of allowable cost information. If DHS classifies a particular type of expense as unallowable for purposes of compiling a rate base, it does not mean that individual providers may not make expenditures of this type.

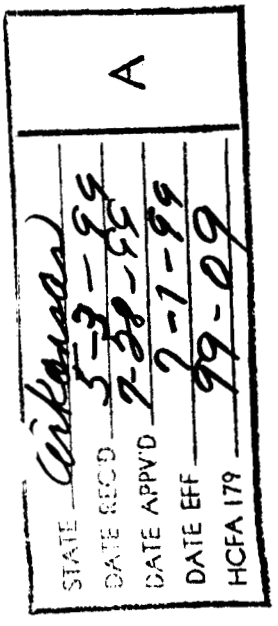
F. Definitions. The following words and terms, when used in this subchapter, shall have the following meanings, unless the context clearly indicates otherwise.

1. Allowable costs — Those expenses that are reasonable and necessary in the normal conduct of operations to provide recipient care in a facility.

a) Reasonable refers to the amount expended. The test of reasonableness is that the amount expended does not exceed the cost which would be incurred by a prudent business operator seeking to contain costs.

b) Necessary costs are those costs essential:

(1) to operate a long term care facility and deliver long term care in conformity with applicable federal, state, and local laws, rules, ordinances, and codes; and



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(2) to attain or maintain the highest practicable physical, mental, and psychosocial well being of each resident.

c) Normal conduct of operations relating to recipient care refers to otherwise allowable costs that include, but are not limited to, the following:

(1) expenses for facilities, materials, supplies, or services used by a facility solely for providing long-term recipient care. Whenever otherwise allowable costs are attributable partially to personal or other business interests and partially to facility recipient care, the latter portion may be allowed on a pro rata basis if the basis for allocation of expense for recipient care purposes is well-documented. This documentation includes the allocation methodology and appropriate logs necessary to support amount attributed to recipient care;

(2) allowable costs which result from arms-length transactions involving unrelated parties. In transactions involving related organizations, the allowable cost to the facility is the cost to the related party. Allowable costs in this regard are limited to the lesser of the actual purchase price to the related party, or usual and customary charges for comparable goods or services.

d) Allowable costs must be reported net of any applicable returns, allowances, discounts, and refunds.

2. Costs of Related Organizations — Costs for services or supplies furnished to the facility by related organizations are allowable at the cost to the related party to the extent that they are reasonable and necessary in the normal conduct of operations relating to recipient care in a facility, and are not in excess of those costs incurred by a prudent buyer. Expenses for transactions with related organizations should not exceed expenses for like items in arms' length transactions with other non-related organizations.

a) Related Organization — A related organization (includes individuals, partnerships, corporations, etc.) is one where the provider is associated or affiliated with, has common ownership, control or common board members, or has control of or is controlled by the organization furnishing the services, facilities or supplies.

b) Common ownership — Common ownership exists when an entity, individual or individuals possess 5% or more ownership or equity in the provider and the institution or organization serving the provider.

c) Control — Control exists where an individual or an organization has the power, directly or indirectly, significantly to influence or direct the actions or policies of an organization or institution.

d) Immediate Family Relationship - Immediate family members are related parties. Immediate family members include husband/wife, natural parent, child, sibling, adoptive child and adoptive parent, step-parent, step-child, step-sibling, father-in-law, mother-in-law, brother-in-law, sister-in-law, son-in-law, daughter-in-law, grandparent, and grandchild.

e) Exception - An exception to the general rule applicable to related organizations exists where large quantities of goods and services are furnished to the general public by the related organization and sales to the facility represent no more than five percent of the gross receipts of the related organization. The facility must demonstrate to the satisfaction of the Department that all of the following criteria are met:

(1) The supplying organization is a bona fide separate organization;

(2) A substantial part of the supplying organization's business activity with the facility is transacted with other organizations not related to the facility and the supplier by common ownership and there is an open, competitive market for the type of services, supplies or facilities furnished by the organization;

(3) The services, supplies, or facilities are those commonly obtained by facilities from other organizations and are a necessary element of resident care.

(4) The charge to the facility is no more than the charge for such services, supplies, or facilities in the open, competitive market, and no more than the charge made by the organization, under comparable circumstances, to other customers for such services, supplies, or facilities.

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f) The facility must furnish to the Department adequate documentation to support the costs incurred by the related organization, including access to the related organization's books and records concerning supplies, services, or facilities furnished to the facility. Such documentation must include an identification of the organization's total costs, and the basis for allocating direct and indirect costs to the facility and to other entities served.

g) Limitations on cost for related party transactions will not apply to the sale of one or more nursing facilities by a person to that person's child or children for money equal to the fair market value of the facility or facilities. All other regulations relating to the sale of a facility will apply.

3. Unallowable Costs — Those expenses that are not reasonable or necessary for the provision of recipient care in a facility, according to the criteria as specified in paragraph (1) of the subsection. Unallowable costs are not included in the rate base used for determining reimbursement rates.

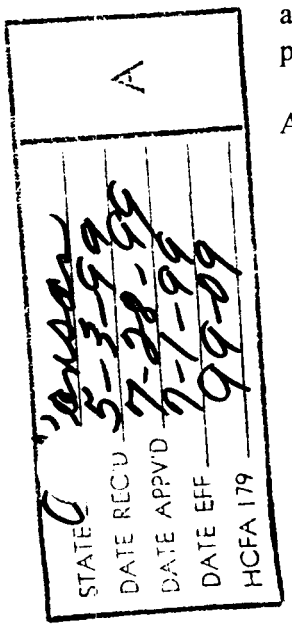
4. Prudent Buyer Concept - Allowable costs may not exceed the cost that a prudent buyer would pay in the open market to obtain products or services.

5. Arms-Length Transaction - A voluntary transaction between a knowledgeable and willing buyer unrelated to the seller, with each acting for his or her own independent self interest.

3-2 List of Allowable Costs

The following list of allowable costs is not all inclusive, but serves as a general guide and clarifies certain key expense areas. The absence of a particular cost does not necessarily mean that it is not an allowable cost. As discussed further in Section 3-4 to follow, certain income items will reduce allowable costs and be offset against the appropriate line items for salaries and wages or other service expenses. Except where specific exceptions are noted, the allowability of all costs is subject to the amounts being reasonable and to the other general principles specified in section 3-1 of this chapter.

A. Compensation of facility employees. This includes compensation for only those employees who provide services directly to the recipients or staff of individual facilities in the normal conduct of operations relating to recipient care: certified nurse aides; nurse aides in training; licensed practical nurses; graduate practical nurses; registered nurses; graduate nurses; other salaried direct care staff; occupational therapists; physical therapists; speech therapists; other therapists; activities personnel; assistant director of nursing; director of nursing; pharmacy personnel; social services personnel; administrator; assistant administrator; food service personnel; housekeeping, laundry, and maintenance staff; medical records personnel; other administrative staff; accounting staff; and data processing



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personnel. Compensation for employees related to the owners, partners, or stockholders of the facility are subject to the limitation established in Section 3-2 B. following. Compensation includes:

1. wages and salaries;

2. the employer's portion of payroll taxes and other mandatory insurance payments. Federal Insurance Contributions Act (FICA or Social Security), Unemployment Compensation Insurance, Workers' Compensation Insurance premiums and other payments mandated by Workers' Compensation laws, including self insurance payments, and payments direct to hospitals or physicians for treating minor injuries.

3. employee benefits. Employer-paid health, life, accident, and disability insurance for employees; uniform allowance and meals provided to employees as part of an employment contract; contributions to an employee retirement fund; and deferred compensation. The allowable portion of deferred compensation is limited to the dollar amount that an employer contributes during a cost reporting period. The expenses:

   a) must represent a clearly enumerated liability of the employer to individual employees;

   b) must be incurred as a benefit to employees who provide services to the recipients or staff of an individual facility; and

   c) must be offered to all full-time non-probationary employees on a equal basis in accordance with an employee benefit policy established in writing. Employers may offer different fringe benefits to different employee classes. Fringe benefits offered to only certain employees within the same employee class of the facility are considered discriminatory fringe benefits and are not allowable. Employee classes must be reasonably related to employee job duties and may not distinguish between persons similarly situated. Reasonable uniform allowances, and life insurance policies on key personnel as required to obtain a loan from an unrelated party, are exempt from this rule.

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B. Compensation of owners, partners, or stockholders. NOTE: These provisions do not apply to corporations whose stock is publicly traded. Compensation will be included as an allowable cost to the extent that it represents reasonable remuneration for managerial, professional, and administrative services related to the operation of the facility and rendered in connection with resident care. Services rendered in connection with resident care include both direct and indirect activities in the provision and supervision of resident care, such as administration,

management, and supervision of the overall institution.

To be included as allowable cost, the compensation shall not exceed 150% of the median wage (excluding non-wage compensation) for comparable positions in facilities that do not have owner operators. Cost Reports from the previous reporting period will be used for setting the ceiling. The HCFA Market Basket projection of inflation will be used to adjust ceilings calculated from the cost reporting period to the rate setting period. Three peer groups will be established for this purpose: 1) Less than 75 licensed beds; 2) 75 to 149 licensed beds; and 3) 150 licensed beds or more. This ceiling is established based on a 40-hour workweek. Owner administrators working less than 40 hours per week must adjust allowable compensation accordingly.

C. Cost of contracted services. This means costs of services defined in 3-1.F.1. procured by contract.

D. Management fees paid to unrelated parties. The department considers management fees paid to unrelated parties as allowable only to the extent that such fees are reasonable and are in accordance with the other general requirements of section 3-1 of this chapter.

E. Management fees paid to related party organizations and other home office overhead expenses. These fees and expenses paid to a related organization may not exceed the actual cost of materials, supplies, or services provided to an individual facility. A facility that is owned, operated, or controlled by other individual(s) or organization(s) may report the allowable portion of costs for materials, supplies, and services provided to that facility. The allowable portion of such costs to a given facility is limited to those expenses that can be attributed to the individual establishment.

1. In multi-facility organizations where the clear separation of costs to individual facilities is not always possible, the allowable portion of actual costs for materials, supplies, and services may be allocated to individual facilities on a pro rata basis. The required allocation method for these costs is a bed day's basis. Providers who wish to use an alternative allocation methodology may do so by obtaining prior written approval from the Director of the Department of Human Services, or the Director's designee, before implementation. Once a provider has chosen an alternative allocation method, and it has been approved, it must be consistently used in preparing subsequent cost reports.

2. In organizations with multiple levels of management, costs incurred at levels above the individual facility in Arkansas are allowable only if the costs were incurred in the provision of materials, supplies or services used by the facility staff in the conduct of normal operations relating to

recipient care. In addition, the facility will make available immediately upon request adequate documentation to demonstrate that the costs satisfy the following criteria:

a) The expense does not duplicate other expenses.

b) The expense is not incurred for personal or other activities not specifically related to the provision of long term care.

c) The expense does not exceed the amount that a prudent business operator seeking to contain costs would incur.

If at the time of the request, records are in active use or are located in a place which makes immediate access impossible or impractical, the facility must certify that fact in writing and deliver the records within 72 hours of the request.

3. Adequate documentation consists of all materials necessary to demonstrate the relationship of personnel, supplies, and services to the provision of recipient care. These materials may include, but are not limited to, accounting records, invoices, organizational charts, functional job descriptions, other written statements, and direct interviews with staff, as deemed necessary by DHS auditors to perform required tests of allowability.

4. A ceiling is established for compensation of owners, partners or stockholders or employees related to owners, partners, or stockholders, employed by a company managing multiple facilities. That ceiling is calculated as follows: For the first two nursing facilities, the ceiling is set at 150 percent of the median wage for non-related administrators for nursing facilities having 150 or more certified beds as provided in Section 3-2 B. For the third facility, the allowable cost is raised by 20 percent of the ceiling for two facilities. For each of the fourth and fifth facilities, the allowable cost is raised by 10 percent of the ceiling for two facilities. Thereafter, for each additional facility, the allowable cost is raised by 5 percent of the ceiling for two facilities. The total allowable cost for an employee must not exceed 200 percent of the ceiling for two facilities.

F. Materials and supplies. This includes but is not limited to:

1. Urological, ostomy, and gastrostomy supplies not billable under Medicare Part B.

2. Intravenous (I.V.) or subcutaneous tray, connecting tubing and needles.